

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: July 15, 2015
To: Board of Governors
From: Governor Tarullo *DICT*
Subject: Draft final order to apply enhanced prudential standards to General Electric Capital Corporation (GECC)

Attached are a memorandum to the Board and a draft final order to be published in the Federal Register that applies enhanced prudential standards to GECC, a nonbank financial company that the Financial Stability Oversight Council has determined should be supervised by the Board.

In light of recently announced plans to sell or distribute large portions of GECC's commercial lending and leasing and consumer lending businesses, definitive timeline to accomplish the plans, and progress made executing the plans, and given that compliance with some of the enhanced prudential standards would require GECC to develop substantial infrastructure and systems, the draft final order establishes two phases for complying with the requirements. Phase one requirements would come into effect as of January 1, 2016, and would require GECC to comply with risk-based and leverage capital, liquidity, and reporting requirements. Phase two requirements would come into effect beginning January 1, 2018, and would require GECC to comply with the liquidity, risk-management, capital-planning, stress-testing, and some other enhanced prudential requirements that apply to large bank holding companies as well as certain governance requirements unique to GECC.

The Committee on Bank Supervision has discussed the draft final order and I believe it is ready for the Board's consideration.

Attachments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: July 15, 2015
To: Board of Governors
From: Staff¹
Subject: Draft final order to apply enhanced prudential standards and reporting requirements to General Electric Capital Corporation

ACTIONS REQUESTED: Approval of the attached draft final order that would apply enhanced prudential standards and reporting requirements to General Electric Capital Corporation (GECC), a nonbank financial company that the Financial Stability Oversight Council (Council) determined should be supervised by the Board. Staff also requests authority to make technical, non-substantive changes to the attached draft final order in order to respond to comments from the Federal Register.

EXECUTIVE SUMMARY:

- Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) directs the Board to establish enhanced prudential standards for nonbank financial companies that the Council has determined should be supervised by the Board in order to prevent or mitigate risks to U.S. financial stability.
- In light of the substantial similarity of GECC's activities and risk profile to that of a similarly-sized bank holding company, the draft final order would apply enhanced prudential standards to GECC that are similar to those that apply to large bank holding companies, including: (1) capital requirements; (2) capital-planning and stress-testing requirements; (3) liquidity requirements; (4) risk-management and risk-committee requirements; and (5) certain additional enhanced prudential standards that reflect unique aspects of GECC's activities, risk profile, and structure.
- The draft final order would implement the standards in two phases. The first set of requirements would come into effect as of January 1, 2016, and the second set of requirements would come into effect as of January 1, 2018.
- The first set of requirements, effective beginning January 1, 2016, would require GECC to comply with the risk-based capital requirements applicable to a bank holding company subject to the standardized methodologies in the Board's regulatory capital framework, the traditional on-balance-sheet leverage ratio, the liquidity coverage ratio rule (LCR rule)

¹ Messrs. Gibson and Van Der Weide, and Mss. Misback, Hewko, Kohli, and MacDonald (Division of Banking Supervision and Regulation), and Mr. Alvarez, Ms. Schaffer, and Messrs. Wilson and Hickman (Legal Division).

applicable to bank holding companies with \$250 billion or more in total consolidated assets or \$10 billion or more in on-balance-sheet foreign exposures (advanced approaches banking organizations), and certain reporting requirements.

- The second set of requirements, effective beginning January 1, 2018, would require GECC to comply with the large bank holding company liquidity risk-management, risk-management, capital-planning, and stress-testing requirements in Regulation YY; the supplementary leverage ratio in the regulatory capital framework; and a 4 percent enhanced supplementary leverage ratio; with certain independence requirements for GECC's board of directors; restrictions on intercompany transactions between GECC and certain affiliates; and additional reporting requirements.

DISCUSSION:

In July 2013, the Council determined that GECC should be subject to supervision by the Board in order to help mitigate the risks that the material financial distress of GECC could pose a threat to the financial stability of the United States. The Dodd-Frank Act provides the Board with authority to examine GECC, including its operations, activities and risk management, and to take a variety of supervisory actions to protect the financial stability of the United States. In addition to these supervisory and examination requirements, section 165 of the Dodd-Frank Act directs the Board to establish enhanced prudential standards for nonbank financial companies that the Council has determined should be supervised by the Board in order to prevent or mitigate risks to U.S. financial stability that could arise from the material financial distress or failure, or ongoing activities of, these companies.² By statute, the enhanced prudential standards must include risk-based and leverage capital requirements, liquidity requirements, risk-management and risk-committee requirements, resolution-planning requirements, single-counterparty credit limits, stress-test requirements, and a debt-to-equity limit for companies that the Council has determined pose a grave threat to the financial stability of the United States.³ Section 165 also permits the Board to establish additional enhanced prudential standards that the Board determines are appropriate.⁴

The Board has issued by rule an integrated set of enhanced prudential standards for bank holding companies and certain foreign banking organizations. These enhanced prudential

² 12 U.S.C. § 5365.

³ 12 U.S.C. § 5365(b)(1)(A).

⁴ 12 U.S.C. § 5365(b)(1)(B).

standards include a capital planning rule,⁵ a stress testing rule,⁶ a resolution plan rule,⁷ and enhanced liquidity requirements.⁸ The Board also adopted an enhanced supplementary leverage ratio (eSLR) for the largest, most complex bank holding companies and has proposed a risk-based capital surcharge framework for U.S. global systemically-important banks (G-SIBs).⁹ This integrated set of standards is designed to enhance the resiliency of these companies and to mitigate the risks that their failure or material financial distress could pose to U.S. financial stability.

In considering the application of enhanced prudential standards to nonbank financial companies supervised by the Board, the Board has stated that it intends to take account of the business model, capital structure, risk profile, and systemic footprint of a designated company.¹⁰ In light of the substantial similarity of GECC's activities and risk profile to that of a similarly-sized bank holding company, the Board proposed to apply enhanced prudential standards to GECC that are similar to those that apply to large bank holding companies. Specifically, the Board proposed to apply: (1) capital requirements; (2) capital-planning and stress-testing requirements; (3) liquidity requirements; and (4) risk-management and risk-committee requirements. The Board also proposed certain additional enhanced prudential standards for GECC in light of the unique aspects of GECC's activities, risk profile, and structure. These included certain independence requirements for GECC's board of directors and restrictions on intercompany transactions between GECC and its affiliates.

After the Board proposed this supervisory and regulatory framework, General Electric Company (GE) and GECC announced a plan to engage in a significant restructuring and refocusing of GECC. Under this plan, GECC would reduce its size over the course of the next three years from approximately \$482 billion in total assets to approximately \$140 billion in total

⁵ 12 CFR 225.8.

⁶ 12 CFR part 252.

⁷ 12 CFR part 243. The Board's resolution plan rule applies by its terms to all nonbank financial companies supervised by the Board. See 12 CFR 243.1(b); 243.2(f)(1)(i).

⁸ See 12 CFR part 249; see also 79 FR 17240, 17252 (March 27, 2014).

⁹ 79 FR 75473 (December 18, 2014).

¹⁰ See Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 FR 17240, 17245 (March 27, 2014).

assets. As part of this reduction it would divest most of its commercial leasing and lending operations; all of its consumer lending activities, including its two insured depository institution subsidiaries; and its commercial real estate businesses, among others. Upon completion of the plan, GECC would focus on certain financing activities related to GE's commercial businesses. The divestitures are subject to a detailed plan with a definitive timeline. GECC has begun executing the plan and has made demonstrable progress. GECC has also announced its intent to request that the Council rescind its designation of GECC as it completes this restructuring effort.

I. Enhanced Prudential Standards.

The Board invited public comment on its proposed application of enhanced prudential standards to GECC. The Board received 21 comments on the proposed order – including comments from GECC, the independent members of GE's board of directors, other companies, industry associations, and individuals. Several commenters supported application of the proposed enhanced prudential standards to GECC, and asserted that it was appropriate to require GECC to comply with standards similar to those applicable to large bank holding companies. Other commenters, however, asserted that the proposed standards were insufficiently tailored to GECC and its business model.

Based on its divestiture plan, GECC requested that the Board delay issuing any final order applying regulatory requirements to GECC so that it may focus on its planned asset sales and related reorganization efforts. In light of GE and GECC's divestiture and reorganization plans and progress made towards accomplishing the objectives of those plans, staff recommends that the Board implement the enhanced prudential standards required by the Dodd-Frank Act for GECC in a tailored manner and in two phases.

A. Phase I Requirements

The first set of requirements, which would become effective on January 1, 2016, include minimum risk-based capital requirements that are the same as those applied to bank holding companies using the standardized methodology, traditional on-balance-sheet leverage ratio requirements, a liquidity coverage ratio requirement, and certain reporting requirements that support the capital and liquidity requirements and the Board's supervision of GECC. GECC has largely implemented all of these requirements.

1. Capital (See p.3)

Bank holding companies that are comparable in size, complexity, activities, and risk to GECC are subject to a capital framework that includes a minimum common equity tier 1 risk-based capital ratio of 4.5 percent, a minimum tier 1 risk-based capital ratio of 6 percent, a minimum total risk-based capital ratio of 8 percent, a common equity tier 1 capital conservation buffer of 2.5 percent of risk-weighted assets, a 4 percent minimum leverage ratio of tier 1 capital to average total consolidated assets (the generally applicable leverage ratio), and a standardized methodology for calculating risk-weighted assets. Because GECC's activities and balance sheet are substantially similar to those of a large bank holding company, the Board proposed to apply the same capital framework to GECC. The draft final order requires GECC, beginning on January 1, 2016, to maintain these standardized risk-based capital requirements and the generally applicable leverage ratio. These regulatory capital requirements will help to ensure that GECC maintains amounts of high-quality regulatory capital commensurate with its risk as it executes its divestiture plan.

2. Liquidity (See p.4)

On September 3, 2014, the Board adopted the LCR rule, which implements a quantitative liquidity requirement consistent with the liquidity coverage ratio (LCR) standard established by the Basel Committee on Banking Supervision.¹¹ The LCR rule is designed to promote the resilience of the short-term liquidity risk profile of large and complex banking organizations, thereby improving the banking sector's ability to measure and manage liquidity risk and to absorb shocks arising from financial and economic stress. Because GECC's activities and balance sheet are substantially similar to those of large bank holding companies, the Board proposed to apply to GECC the requirements in the LCR rule that apply to advanced approaches banking organizations beginning July 1, 2015. The proposed order would have adopted the same transition periods and compliance timelines for GECC as applied to all other advanced approaches banking organizations that have less than \$700 billion in total consolidated assets and less than \$10 trillion in assets under custody. These transition periods would have permitted GECC to report LCR calculations on a monthly (rather than daily) basis until July 1, 2016, and

¹¹ 79 FR 61440 (October 10, 2014); 12 CFR part 249.

would have required GECC to maintain an LCR of at least 80 percent from July 1, 2015 to December 31, 2015, an LCR of at least 90 percent from January 1, 2016 to December 31, 2016, and an LCR of at least 100 percent thereafter.¹²

GECC requested that the Board defer the requirement to calculate its LCR daily until January 1, 2018. In recognition of the infrastructure necessary for daily LCR calculations, staff recommends that the Board defer requiring daily LCR calculations until January 1, 2018, and allow GECC to calculate its LCR monthly beginning January 1, 2016. The draft final order requires GECC to calculate and maintain an LCR of at least 90 percent LCR beginning January 1, 2016, to December 31, 2016, and an LCR of at least 100 percent from January 1, 2017, thereafter. This approach provides a reasonable amount of time for GECC to prepare to comply with the LCR rule. Further, the standardized requirements of the LCR rule will allow for horizontal comparisons between GECC and other companies with similar balance sheets and risk profiles.

GECC also requested that application of the LCR rule to GECC be tailored to reflect GECC's inability to hold significant Federal Reserve Bank balances and its holding of substantial amounts of deposits at third-party banks. While nonbank companies do not have access to central bank reserves, the draft final order does not alter the application of the LCR rule to GECC. Deposits with third-party banking organizations do not meet the Board's LCR criteria for high quality liquid assets because, during a liquidity stress event, many commercial banks may exhibit the same liquidity stress correlation and wrong-way risk. In addition, the LCR counts as high quality liquid assets various high-credit-quality securities other than central bank reserves, all of which are available to GECC. Moreover, adopting GECC's modification regarding third-party commercial bank deposits could reduce the value of horizontal comparisons between GECC and other companies with similar balance sheets and risk profiles.

B. Phase II Requirements

The second set of requirements impose enhanced risk management, capital, capital planning, stress-testing, liquidity, and inter-affiliate transaction requirements, as well as certain additional reporting requirements. These requirements would be deferred until January 1, 2018. This will allow GECC time to complete its reorganization plan, and to invest resources and to

¹² 12 CFR 249.50(b).

develop processes, procedures, and policies in the event the reorganization plan is not completed or the Council does not designate GECC upon completion of the plan. If that plan results in the Council's rescinding of the designation of GECC by January 1, 2018, these standards would not be applied to GECC.

1. Risk-Management Requirements (See p.4)

To ensure that GECC's board of directors included members who were independent of GE, and whose attention was focused on the business operations and safety and soundness of GECC, the proposed order would have required that two or more of the directors of GECC be independent of GECC's management and of GE's management and board of directors. One of these directors would have been required to serve as the chair of GECC's risk committee. In addition, consistent with requirements applicable to large bank holding companies, GECC would have been required to maintain at least one director on its risk committee with expertise in "identifying, assessing, and managing risk exposures of large, complex financial firms." Finally, the proposed order would have required GECC to observe the Board's existing risk-management guidance and supervisory expectations for large financial institutions and nonbank financial companies supervised by the Board.

While acknowledging the importance of the proposed heightened risk management requirements, several commenters, including GECC and the independent directors of GE and corporate governance associations, argued that the proposed requirement that at least two GECC directors be independent of both management and the board of directors of GE would create uncertainty about the responsibilities of the independent directors of GECC, who would be expected under the Board's proposed order to focus on the risks at GECC alone and who would simultaneously owe a fiduciary duty to GE as the sole shareholder of GECC.

After considering the public comments, staff recommends that the Board not adopt the proposed requirement that a minimum number of directors on GECC's board be independent of the GE board. This requirement likely is unnecessary to ensure that the perspectives of qualified individuals independent of the management of GE and GECC will have a strong voice in the governance of GECC and to counterbalance any tendency to operate GECC in a manner that, while advantageous to GE as the sole shareholder of GECC, may pose risks to the financial stability of the United States. Instead, staff recommends that, beginning January 1, 2018, a majority of the GECC board of directors be required to be independent of GE management or

GECC management, and that an independent director chair the board and risk committee at GECC.

The draft final order would maintain the requirement, generally supported by commenters, that, beginning January 1, 2018, the entire GECC risk committee be comprised of independent directors, unaffiliated with GE management or GECC management. The draft final order also requires GECC to comply with the risk committee and risk-management framework in section 252.33 of the Board's Regulation YY, beginning January 1, 2018.

2. Capital Requirements (See p.5)

The proposed order would have required GECC generally to comply with the measures in the Board's capital framework applicable to the largest, most interconnected bank holding companies. The proposed order, however, would not have required GECC to calculate its risk-based capital ratios under the advanced approaches risk-based capital rules (advanced approaches rule). Rather, the proposed order would have required GECC to calculate its risk-based capital ratios only under the standardized approach. The proposed order noted that although GECC's assets exceed the threshold for application of the advanced approaches rule, GECC has not previously been subject to regulatory capital requirements and has not developed the infrastructure and systems required to begin calculating its risk-based capital ratios under the advanced approaches rule. The proposed order would have required GECC to comply with other aspects of the regulatory capital framework that apply to advanced approaches banking organizations.¹³

GECC requested that the Board allow it to exclude recognition of accumulated other comprehensive income (AOCI) relating to certain investment securities in regulatory capital. Because of the similarities in activities, size, risk, and exposures of GECC to large bank holding companies, the draft final order requires GECC to recognize most elements of AOCI in regulatory capital as of January 1, 2018, and finalizes the other enhanced risk-based capital requirements as proposed. To account for the divestiture plan and the need to build systems to

¹³ These include restrictions on distributions and discretionary bonus payments associated with the countercyclical capital buffer, a minimum supplementary leverage ratio of 3 percent, and the requirement to include most elements of accumulated other comprehensive income in regulatory capital.

account for these requirements, these enhanced capital standards would become effective January 1, 2018.

The proposed order would have required GECC to comply with a 5 percent eSLR in order to avoid restrictions on capital distributions and discretionary bonus payments to executive officers. GECC asserted that subjecting GECC to the eSLR was inappropriate because GECC does not meet the size threshold for application of the eSLR to bank holding companies (\$700 billion in total consolidated assets or \$10 trillion in assets under custody).

The draft final order retains eSLR standards for GECC, but tailors the standards to GECC's risk profile, complexity, activities, and size. Specifically, the draft final order would require GECC to exceed a 4 percent enhanced supplementary leverage ratio in order to avoid restrictions on distributions and certain discretionary bonus payments, as opposed to the 5 percent enhanced supplementary leverage ratio required for other institutions subject to the eSLR. The lower requirement in the final order is intended to reflect GECC's smaller systemic footprint compared to other banking organizations subject to the eSLR, while still minimizing leverage at GECC and reducing the likelihood that problems at GECC would cause it to fail in a manner that disrupts financial stability.

3. Capital Planning and Stress-testing Requirements (See pp.6-7)

The proposed order would have required GECC to comply with the Board's capital plan rule, which requires annual submission of an assessment of a company's sources and expected uses of capital under both expected and stressed conditions, and to submit its first capital plan in the capital plan cycle beginning January 1, 2016. The proposed order would also have required GECC to comply with the stress-testing requirements applicable to bank holding companies with \$50 billion or more in total consolidated assets under the Board's stress test rule starting with the stress-testing cycle beginning on January 1, 2017.¹⁴ Commenters generally supported applying capital planning and stress-testing requirements to GECC. GECC requested that the Board defer implementation of capital planning and stress testing in order to allow GECC sufficient time to develop the necessary internal systems and ultimately, focus its capital plan compliance and stress-testing efforts on the businesses and assets it intends to retain after its proposed divestitures.

¹⁴ 12 CFR part 252, subparts E and F.

The draft final order generally adopts the capital-planning and stress-testing requirements without substantive modification. Because the final structure of GECC is material to GECC's implementation of these requirements, the final order would delay application of those standards to the cycles beginning January 1, 2018 for capital planning, and January 1, 2019 for stress testing.

4. Liquidity Requirements (See p.8)

To complement the LCR requirements, the proposed order would have applied the individualized liquidity risk-management requirements established in Regulation YY,¹⁵ without change, to GECC in order to help ensure that GECC develops the necessary infrastructure to evaluate and control the liquidity risk profile of its operations on a continuing basis. The liquidity requirements in Regulation YY require large bank holding companies to conduct internal liquidity stress tests and hold a buffer of highly-liquid assets that is sufficient to meet the company's projected net stressed cash-flow need over a 30-day period based on the results of such internal stress tests. The Board also proposed to apply the liquidity expectations outlined in SR Letter 10-6, Interagency Policy Statement on Funding and Liquidity Risk Management, to GECC. SR 10-6 reiterates the process that institutions should follow to appropriately identify, measure, monitor, and control their funding and liquidity risk. The guidance also explains the expectation that institutions manage liquidity risk using processes and systems that are commensurate with the institution's complexity, risk profile, and scope of operations.

GECC requested that the Board not apply intraday liquidity monitoring requirements, asserting that GECC's business mix does not result in high intraday liquidity volatility. In order to promote the resilience of GECC, improve its ability to withstand financial and economic stress, and mitigate the potential adverse effects of GECC's distress or failure on other financial firms and markets, the draft final order would require GECC to manage its liquidity in a manner that is comparable to a bank holding company of comparable size and similar liquidity risks, including intraday liquidity monitoring. Intraday liquidity monitoring is an important component of the liquidity risk management process. An institution that is unable to meet critical payments

¹⁵ 12 CFR 252.34, .35.

has the potential to lead to systemic disruptions. These requirements would apply beginning January 1, 2018.¹⁶

5. Restrictions on Intercompany Transactions (See p.9)

The draft proposed order would have required all transactions between GECC and affiliated entities that are not under GECC's control to be on market terms. This would address the possibility that transactions between GECC and its affiliates could have an adverse effect on the financial condition of GECC. While acknowledging that these requirements were appropriate, GECC recommended that the Board apply the requirements only on a prospective basis. GECC argued that a review of prior transactions and existing contractual relationships would be time-consuming, costly, and of limited benefit.

Staff recommends that all of GECC's loans and extensions of credit, including a purchase of assets subject to an agreement to repurchase, that are outstanding on or after January 1, 2018, and all transactions covered by section 23B of the Federal Reserve Act initiated on or after January 1, 2018, comply with the requirements of section 23B of the Federal Reserve Act and the corresponding provisions of Regulation W in order to ensure the safe and sound operation of GECC. While staff recognizes that there could be a cost in conforming existing arrangements to section 23B, the costs exist only to the extent that GE affiliates have received terms in transactions with GECC that are not at least as favorable to GECC as would be available in the marketplace, while at the same time, such transactions result in GECC providing a subsidy to GE or its affiliates, thereby increasing the cost and risk to GECC.

II. Reporting Requirements (See p.10)

The proposed order would have required GECC to file the following reports. Each of these reports is required of large bank holding companies and is designed to assist the Board in its supervision of GECC.

- the FR Y-6 report (Annual Report of Holding Companies);
- the FR Y-10 report (Report of Changes in Organizational Structure);
- the FR Y-9C report (Consolidated Financial Statements for Holding Companies) and FR Y-9LP report (Parent Company Only Financial Statements for Large Holding Companies);

¹⁶ See 12 CFR 252.34, .35.

- the FR Y-11 and FR Y-11S report (Financial Statements of U.S. Nonbank Subsidiaries of U.S. Holding Companies);
- the FR 2314 report and FR 2314S Report (Financial Statements of Foreign Subsidiaries of U.S. Banking Organizations);
- the FR Y-14A, FR Y-14M, and FR Y-14Q reports (Capital Assessments and Stress Testing) (together, the FR Y-14 series reporting forms);
- the FR Y-15 report (Banking Organization Systemic Risk Report);
- the FFIEC 009 report (Country Exposure Report) and FFIEC 009a report (Country Exposure Information Report); and
- the FFIEC 102 report (Market Risk Regulatory Report for Institutions Subject to the Market Risk Capital Rule), if the market risk capital rule becomes applicable to GECC.

In comments on the proposed order, GECC requested that certain reporting requirements be delayed and that for those subsidiaries that would be unwound or sold as part of the divestiture plan, GECC should be permitted to defer the quarterly and annual reporting of standalone financial statements until the first quarter of 2018. In recognition of GECC's divestiture plan, the draft final order requires GECC to begin filing the FR Y-6, FR Y-10, FR Y-9C, FR Y-9LP, and FR Y-11 and Y-11S reports in connection with the Phase I Requirements beginning on January 1, 2016, and the remainder in connection with the Phase II Requirements beginning on January 1, 2018. The draft final order also provides for an ability to modify the reporting requirements going forward if GECC's circumstances change.

CONCLUSION: Based on the foregoing, staff recommends that the Board approve the attached draft final order. Staff also recommends that the Board delegate to staff the authority to make technical and minor changes to the attached materials in order to respond to comments from the Federal Register.

Attachment